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THE NEW GENERATION OF PRIVATE-SECTOR DEVELOPMENT PROGRAMMING: THE EMERGING PATH TO ECONOMIC GROWTH WITH POVERTY REDUCTION

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The Accelerated Microenterprise Advancement Project (AMAP) is a four-year contracting facility that U.S. Agency for International Development (USAID)/Washington and Missions can use to acquire technical services to design, implement, or evaluate microenterprise development, which is an important tool for economic growth and poverty alleviation.

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Contractor: Development Alternatives, Inc.

Authors:

Jeanne Downing
Don Snodgrass
Zan Northrip
Gary Woller

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1. INTRODUCTION

This paper presents a conceptual framework for understanding the new generation of private-sector development (PSD) programming developed since the mid-1990s by USAID and other donors. The framework offers an exploratory model of PSD and defines the range of options open to donors seeking to accelerate and/or improve PSD in developing and transition economies.

This paper is the third of five AMAP Business Development Services (BDS) Knowledge & Practice (K&P) Component D papers related to impact assessment of PSD programs. Its purpose is to lay the foundation on which to build an approach for conducting impact assessments of an array of PSD activities. To do so, it describes the impacts that PSD programs aim to achieve, strategies and programmatic approaches used to achieve these impacts, and the implications of these aims, strategies, and approaches for measuring their success. The paper ends by defining a learning agenda derived from the new generation of PSD programs.

The first two K&P Component D papers were a survey of recent evaluations and impact assessments carried out by donors and an inventory of donor projects in PSD.[1] The fourth paper will build on this paper to lay out a rationale and strategy for assessing the impact of PSD programs. It will also provide a consistent impact assessment framework that will enhance the comparability of different impact assessments and improve understanding of the factors of success and failure in such activities.

The fifth paper is actually a series of short interrelated methodology notes providing Mission staff and evaluation practitioners a set of practical tools for planning, designing, and undertaking impact assessments of PSD programs.

The present paper has nine sections. Following this Introduction, section 2 defines the importance of PSD for economic growth and poverty alleviation. Section 3 then presents a model of PSD that, while perhaps implicit in recent intervention designs, has not been fully articulated before now. Sections 4 through 6 discuss the three major elements in that model: end-market demand, the business environment, and private-sector supply response.

Section 7 describes the new generation of PSD programming and analyzes the major strategic issues that donors face when they design interventions intended to stimulate PSD. Section 8 discusses the varied settings in which PSD programs are implemented and their implications for program design. Finally, Section 9 defines a learning agenda for determining the effects of new generation PSD projects.

[1] See Lily Zandniapour, Jennefer Sebstad, and Donald Snodgrass, *Review of Impact Assessments of Selected Enterprise Development Programs*, MicroReport #3, AMAP BDS K&P, USAID, Development Alternatives, Inc. (DAI) (July 2004); Donald Snodgrass with assistance from Lara Goldmark, Jenny Pan, Tsitsi Makombe, and Matthew Rees, *Inventory and Analysis of Donor-Sponsored MSE Development Programs*, MicroReport, AMAP BDS K&P, USAID, DAI (January 2005).

2. ECONOMIC GROWTH, POVERTY, AND PRIVATE-SECTOR DEVELOPMENT

While language and emphasis differ slightly, all donors seek to promote both economic growth and poverty reduction. Economic growth still means rising gross domestic product (GDP) per capita to some, while others prefer more complex definitions. The simplest definition of poverty (the "poverty headcount") measures the number of people or proportion of the population who live below a defined poverty line. More complex definitions of poverty take account of the absolute income or consumption levels of the poor.

Popular phrases that try to consolidate these two basic objectives are "economic growth with poverty reduction" and "pro-poor growth." Broadly, these phrases imply that economic growth must benefit the poor. Concretely, they could mean either that the income of the poor must rise during economic growth or, more demandingly, that the incomes of the poor must rise faster than those of the non-poor. The stricter definition implies that the distribution of income must equalize.[2] One could add further rigor to the definition of pro-poor growth by requiring that economic growth also reduce the risks faced by the poor and help them retain and build assets.

Economic growth is an essential element for poverty reduction. Following extensive debate over the years, "there is now widespread agreement that increasing average incomes [GDP per capita] is a necessary condition for reducing poverty and that the higher and more sustained the rate of growth, and the longer sustained, the more rapid poverty reduction."[3] Research shows that, on average across countries, economic growth causes the income of the poor to rise about as rapidly (in percentage terms) as the income of the non-poor.[4]

There is, however, considerable cross-country variation around this average, as well as substantial two-way traffic back and forth across the poverty line. As some households are able to lift themselves out of poverty, others sink below the poverty line once more—often because of personal tragedies such as severe sickness and death.[5] Economic growth is more likely to reduce poverty if it starts from a position of low income and wealth inequality, raises earnings from micro and small enterprises (MSEs) owned by the poor, and creates large amounts of employment.

The poor benefit from economic growth through four distinct channels.[6] All four channels in turn depend on private-sector expansion.

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[2] A recent U.K. Department for International Development (DFID) paper notes both of these possible definitions and also observed that donors can focus on the marginally poor (those who might readily be lifted above the poverty line), the extreme poor, or the average income of all those below the poverty line. See DFID, *Accelerating Pro-Poor Growth through Support for Private Sector Development*, (2004) p. 9.

[3] DFID (2004), pp. 9-10.

[4] John Gallup, Steven Radelet, and Andrew Warner, *Economic Growth and the Income of the Poor*, Harvard Institute for International Development (1998); David Dollar and Aart Kray, *Growth is Good for the Poor*, World Bank (2001). See also World Bank, *Pro-Poor Growth in the 1990s: Lessons and Insights from 14 Countries* (2005).

[5] For urban India, see Martha Chen and Donald Snodgrass, *Managing Resources, Activities, and Risk in Urban India: The Impact of SEWA Bank*, USAID AIMS Project (2001). For rural India, see Anirudh Krishna, *Escaping Poverty and Becoming Poor: Who Gains, Who Loses, and Why?,* Sanford Institute of Public Policy, Duke University (2002).

[6] DFID (2004), pp. 11-12.

As farmers and entrepreneurs: Economic growth increases demand for goods and services produced by MSEs owned and operated by the poor. The impact of economic growth on demand is particularly strong when combined with policies that reduce regulatory bias and improve MSEs' access to markets, the inputs they buy, and the business services that they use (financial and other).

As workers: Growth in the demand for goods and services increases the demand for labor. The impact of economic growth on poverty is particularly strong when increased demand for goods and services is felt in sectors that can employ large numbers of poor people at wage levels higher than their current income.

As consumers: Many of the goods and services that poor people consume are produced by MSEs. Low-income consumers benefit from the lower prices that are often charged for these goods and service.

As potential recipients of tax-funded services or transfers: Economic growth boosts government revenues, which can finance expansion of services like elementary education and basic health if policy makers so decide. Free or low-cost access to such public services can significantly enhance the welfare of the poor.

PSD is thus critical for achieving economic growth with poverty reduction. The private sector is a large and growing segment of nearly all economies. Factors working to increase its importance in developing and transition countries include the collapse of socialism, privatization, and the declining importance of public-sector oil and gas revenues in some petroleum-producing countries. The private sector is also the main source of the innovation and dynamism on which investment, and thus economic growth, depends.[7]

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[7] Although governments frequently intervene in technology acquisition and adaptation, upgrading national technological capacity is primarily the task of the private sector. Research shows that, dollar for dollar, private investment contributes more to economic growth than public investment (see Lawrence Bouton and Mariusz A. Sumlinski, *Trends in Private Investment in Developing Countries: Statistics for 1970-1998,* Discussion Paper IFD 41. Washington, D.C.: International Finance Corporation (2000)). Entrepreneurs, motivated by profit opportunities, will seek out ways to improve production technology.

3. A FRAMEWORK FOR PRIVATE-SECTOR DEVELOPMENT

As an aid to understanding how the private sector develops and what, therefore, might be done to promote PSD in developing and transition countries, a formal but simple model of private-sector development is presented in this section. PSD can be thought of as driven by three factors.

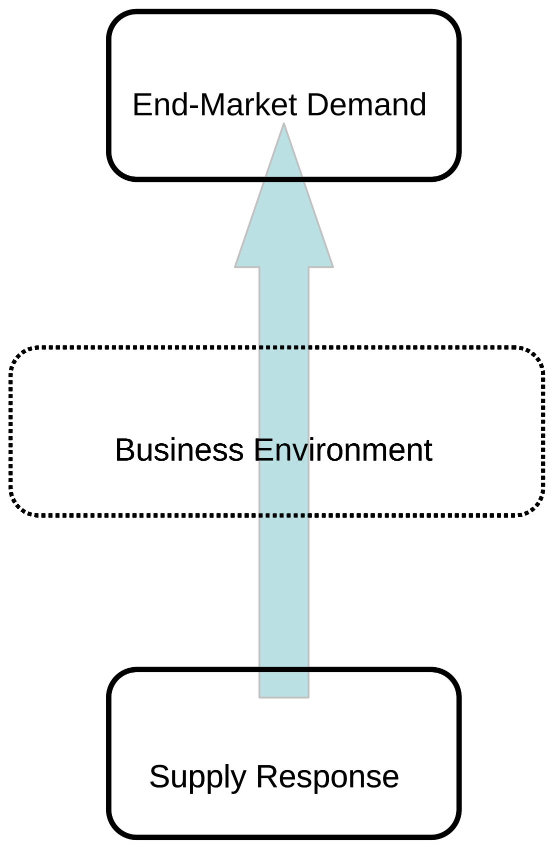
First, there must be end-market demand for products. Demand—from consumers, other producers, and governments, either local or foreign—provides the all-important profit incentive for firms to raise production, expand employment, upgrade production methods, improve productivity, and achieve greater competitiveness. Demand is generally exogenous but can sometimes be influenced through branding and product differentiation.

Second, the business environment in which enterprises operate acts as a filter through which product demand reaches the private sector in effective form. The business environment comprises a host of influences at the global, national, regional, and industrial levels. It affects PSD by imposing high or low transaction costs and increasing or decreasing business risk.

The third factor is the supply response, the ability of enterprises to respond to the incentives with which they are presented. The response strategies of individual firms often involve cooperative linkages with other firms. These linkages can be vertical (with firms at either higher or lower levels of the value chain) or horizontal (with other firms at the same level). Strengthening such linkages can facilitate production processes and improve market access. The development of supporting markets (for finance, inputs, business services, labor skills, land, and capital equipment) is also important.

The relationship among the three factors is shown in Figure 1. Further discussion of each factor follows.

FIGURE 1: A FRAMEWORK FOR PRIVATE-SECTOR DEVELOPMENT



4. END-MARKET DEMAND

Demand for the goods and services that individual enterprises and the private sector as a whole produce is critical for their growth. If goods cannot be sold, no wise businessperson will produce them. Enterprises of all types and sizes are motivated by the profits to be made by supplying goods and services to those who demand them.

In very poor countries, most firms are limited to serving local markets because poor transportation and communication infrastructure make it too costly to ship goods for sale in more distant locations. This restricts firms' ability to specialize and innovate. As Adam Smith famously observed in *The Wealth of Nations* (1776), the division of labor is limited by the extent of the market. As countries develop, transportation and communication improve, allowing markets to become better integrated. This may enable firms to sell their products profitably throughout the country.

Often, however, the national market itself is both small and stagnant. Market size (approximated by aggregate GDP), and thus the demand for goods and services, is often small because of low per capita income, an inequitable distribution of income, limited differentiation of the structure of production in the national economy, and small national populations. When the growth rate of GDP is also low, the severe constraint of low domestic purchasing power is eased only slowly over time. The exact nature of the demand problem that enterprises face varies by country as well as by the product or service involved.

Firms produce for either end users (consumers and government) or intermediate users (other producers). Goods purchased by better-off consumers may find an adequate market in a middle-income country—or even in a low-income country with a large population and therefore a sizeable middle class (such as India)—but they will probably not be produced domestically in the typical smaller, low-income country. The distribution of income affects the demand for consumer products. Governments' purchasing power is limited by their revenues, which depend on the tax base. Finally, intermediate products used by manufacturers (inputs and capital goods) will register little effective demand unless the manufacturing industry in question operates in the country.

In principle, export sales—including sales to neighbors and other developing countries as well as to developed countries—offer an escape from the demand constraints facing many firms in developing countries. Economic theory suggests that when a producer supplies only a small share of the world market for a particular product or service (which would be the case for nearly all developing country firms as well as for the countries as a whole), it can sell as much as it produces without affecting the world price. In theory, there is no demand constraint in the global market.

In practice, however, developing country exporters may face trade barriers such as tariffs, quantitative restrictions, and health and safety standards that are difficult and expensive to satisfy. The more successful they are, the more likely it is that protectionist barriers may be thrown up to impede their overseas sales. So the export market is not the panacea that it appears to be in economic theory; product demand remains a major challenge in PSD.

5. BUSINESS ENVIRONMENT

The incentives created by product demand are filtered by the business environment before they reach the firm. The business environment may be more or less favorable for enterprise formation and development.[8] A favorable (enabling) environment provides producers with a clear picture of both foreign and domestic demand, offers economic and political stability, facilitates low transaction costs (for example, costs of entering into and enforcing contracts), and maintains relatively low levels of risk for business transactions.[9] It allows for efficient business operations that embody investment, innovation, and creativity.

An unfavorable (disabling) environment obscures demand incentives, creates political and economic uncertainty, imposes high transaction costs, and raises business risks. While businesses can and do survive (and sometimes even thrive) in even the most perverse environments, the quality of the business environment has a major impact on both the scale and scope of the economic growth that PSD can deliver.

The business environment can be segmented into four distinct, yet interrelated, environments: global, national, local, and industrial business.

The ***global business environment*** includes international trade regimes (e.g., World Trade Organization [WTO], North American Free Trade Agreement), tariffs and non-tariff trade barriers, and public and private standards that are imposed above the level of the producing nation. For example, end-market demand for sugar may be high, but international trade regimes and the broad prevalence of production subsidies may prevent the full extent of that demand from being served by the most efficient producers. Quality and quantity standards, set either by national authorities of importing countries or, increasingly, by global retailers, may also create barriers to developing country production.

The ***national business environment*** embodies a country's unique characteristics, including its geographic features, infrastructure, economic and social policies, institutions, and governmental stability.[10] Most aspects of a favorable national business environment, however, are created by human action:

Security and public safety;

Macroeconomic stability, achieved through appropriate monetary and fiscal policies;

Privatization of public-sector activities that can be carried out better by the private sector;

An appropriate and well-regulated financial system;

A commercial law regime that respects property rights and facilitates the creation and operation of businesses, the creation and enforcement of contracts, and the ability to profit from innovation;

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8 The World Bank's Doing Business series has recently introduced comparable cross-country information on the quality of the business environment (which the World Bank calls the investment climate). These measures, however, cover only a few aspects of the business environment and often apply to a specific type of firm (a limited liability company doing business in the national capital). Schiffer and Weder demonstrate that in most countries the business environment is less favorable for small firms. See Mirjam Schiffer and Beatrice Weder, *Firm Size and the Business Environment: Worldwide Survey Results,* Discussion Paper 43. Washington: International Finance Corporation (2001).

9 Some degree of risk is inherent in business enterprise. Some theorists regard profit as the payment received by entrepreneurs for their willingness to bear business risk.

10 Tyler Biggs, *The Investment Climate and Private Sector Development* (2004).

Honest and efficient public administration;

Competition policy that breaks up monopolies, protects consumers, and regulates natural resource use;

Labor law that protects workers and allows them to organize while encouraging necessary labor mobility;

The human and "knowledge" capital possessed by the population;

Physical infrastructure, including energy, transportation, communication, and water resources systems; and

Social infrastructure, including health system, pension system, other social safety nets.[11]

Many discussions of the business environment—which the World Bank calls the *investment climate*—employ a narrower definition that is limited to national laws and regulations that affect business activities such as opening and closing firms, entering into contracts, obtaining credit, and hiring and firing workers. This narrower focus may or may not be appropriate, depending on the setting.

The ***local business environment*** is heavily influenced by local enforcement of national laws and regulations, which often varies considerably both from the original legislative intent and from the directions provided by national implementing agencies. Provision of physical and communications infrastructure at the local level is also important in determining whether, and at what cost, demand can be perceived, inputs can be sourced, and finished goods can be delivered.

The ***industrial business environment*** depends less on geography or jurisdiction than on the characteristics of specific value chains, which often cross national boundaries.[12] Each value chain has a unique ecology that can be characterized by the nature of the *relationships* among value chain participants. These relationships determine patterns of value chain *learning*, as well as the scale and scope of *benefits* accruing to various participants in the value chain. Relationships, learning, and benefits together determine the ability of firms to upgrade in terms of product, process, or value chain function. For example, Acer and other Taiwanese electronics firms began as suppliers of components produced to specification for overseas customers but learned how to upgrade functionally over time, establish global brands, and introduce increasingly complex and even path-breaking products.

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[11] See Donald R. Snodgrass and James Packard Winkler, *Enterprise Growth Initiatives: Strategic Directions and Options.* Bethesda, MD: DAI., (2001) p. 26.

[12] We define a value chain as the full range of activities that are required to bring a product from its conception to its end use. These include design, production, marketing, distribution, and support to get the product to the final user. The activities that comprise a value chain may be contained with a single firm or may embrace many firms. They can be limited to a single country or span national boundaries.

6. SUPPLY RESPONSE

Supply response refers to the ability of private enterprises and industries to meet the demand for goods and services. Individual private firms have unequal abilities to respond to incentives and meet the demand for the goods and services that they produce, or could produce. Some of this difference can be traced to factors internal to the firm: varying knowledge and skills regarding products, markets, and technologies, as well as differences in entrepreneurial and managerial ability. However, increasing recognition is being given to the fact that the supply response is a function not only of an enterprise's efficiency and its understanding of its customers' needs but also of the ability of an entire industry to compete with other industries in other countries. As a result, networks of firms can be critical to the ability of an enterprise to respond to market signals and improve competitiveness.

Competitiveness is fundamental to the successful response of industries and/or networks of enterprises to market demand. Competitiveness is the ability of an economic entity (firm, industry, value chain, or nation) to create a competitive advantage that differentiates it from its market rivals and which those rivals find it difficult or uneconomic to replicate. Professor Michael Porter of the Harvard Business School suggests that there are three ways to achieve competitive advantage: 1) improved efficiency/cost advantage;[13] 2) product differentiation and/or the uniqueness of the product or service in terms of its price/quality ratio and brandability; and 3) shaping demand around unique characteristics (that is, an industry's ability to take advantage of changes in demand—for example, a shift in demand from commodity coffee to specialty coffee).

6.1. NETWORKS

Networks of firms (which could also be called market systems or, more commonly, industries) are important for achieving competitiveness. These networks can take the form of *clusters* of enterprises producing similar products or of *value chains,* and may involve external suppliers, processing agents, marketing firms, think tanks, banks and other financial institutions, consulting firms, government entities, and others.[14] Whether made up of firms linked vertically to markets and/or horizontally to each other, networked firms can deliver access to product markets and to supporting markets for inputs, finance, and business services, all of which are vital for strong supply response.

In economic terms, business networks are a means of generating external economies or collective efficiencies. By cooperating with other firms on certain aspects of the value creation process (e.g., processing, branding, and marketing), enterprises can increase the total value that they jointly create. The potential for achieving such collective efficiencies is the reason that business networks are important for achieving competitiveness. At the same time, inter-firm cooperation and business linkages form a kind of bridge between demand and supply, which enables firms to access markets in which there is a demand for their products but which they would otherwise be unable to reach. Today, business relationships increasingly stretch around the world. Networks expedite the flow of information, reduce transaction costs, and can serve as the basis for policy dialogue on key reform issues.

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[13] This can be defined as the price at which the industry can supply a product or service of minimal acceptable quality to the public.

[14] We define a cluster as a group of enterprises that are geographically linked, offering the potential for external economies. A cluster can include parts of one or more value chains, along with supporting markets and organizations such as trade associations, universities and vocational schools, financial institutions, and local and national-level government agencies.

6.1.1. CLUSTERS

Business networks can be vertical (value chains) or horizontal (clusters). Porter associates competitiveness at the national and regional levels with the growth of clusters—horizontal linkages among firms that significantly complement the efforts of the individual enterprises that make up the cluster. In the United States and other developed countries, numerous clusters have developed from private-sector and sometimes public-sector or mixed activities. Clusters can provide a range of collective efficiencies, as when hotels, tourist attractions, restaurants, and air carriers cooperate to promote particular tourist destinations. A number of current projects sponsored by USAID and other donors are attempting to stimulate the creation of clusters in developing countries. While the returns are not all in, it may be that strong clusters form and grow organically while efforts to promote their development face an uphill struggle, especially in developing countries.

6.1.2. OTHER FORMS OF HORIZONTAL LINKAGE AND INTER-FIRM COOPERATION

Other forms of horizontal linkage that may help boost competitiveness include producer groups that may be formally or informally organized—as cooperatives, producers' associations, or exporters' associations. These and other forms of business member organizations (BMOs) can improve the efficiency of a value chain or cluster, for example, by helping large numbers of small-scale producers link up with lead firms that possess good access to selected export markets.

6.1.3. VALUE CHAINS: VERTICAL LINKAGES AND INTER-FIRM COOPERATION

To reach wider markets abroad and at home, small firms often need to establish vertical linkages with processors and distributors that have direct access to these markets. Relationships within global, national, or even local value chains also have a major influence on local firms' ability to upgrade by improving their production processes, moving into more sophisticated product lines, and acquiring new functions within the value chain.

Humphrey and Schmitz identify four major governance patterns within (especially global) value chains:

Arm's length market relations, in which buyer and seller do not establish close relations because the product is standardized and the buyers' requirements can be satisfied by purchasing from any of a range of firms.

Networks, in which firms cooperate to divide functions among them. Buyers may set certain product or process standards, but they are confident that the suppliers will meet them.

Quasi-hierarchy, in which one firm exercises a high degree of control over others in the value chain, often specifying product characteristics. This implies some doubts about the competence of suppliers in the chain.

Hierarchy, in which a lead firm acquires direct ownership of some operations in the value chain, making them subsidiaries.[15]

Although many simple commodities are traded internationally through arm's length market relationships, entering lines of production and trade in which higher value added can be earned usually requires a lead firm in a developing or transition country to connect to a network, if not to

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[15] John Humphrey and Hubert Schmitz, "Chain Governance and Upgrading: Taking Stock," in Hubert Schmitz, ed. *Local Enterprises in the Global Economy: Issues of Governance and Upgrading* (Cheltenham, 2003).

enter into a quasi-hierarchical relationship. According to Humphrey and Schmitz, quasi-hierarchical value chains enable developing country firms to upgrade their products and processes but offer little opportunity for functional upgrading.

Humphrey and Schmitz use these governance patterns to describe the power dynamics between those who govern the chain—be they buyers or suppliers (or neither in the case of the arm's length market pattern), dictating the rules regarding product specifications, quantity, quality, and/or delivery—and less powerful participants. The kinds of power dynamics embedded in the governance concept exist throughout the chain at every step of value added.

6.2. THE IMPORTANCE OF SUPPORTING MARKETS FOR SUPPLY RESPONSE

Supporting markets, including finance and sector- and non-sector specific business services and products, are important for both for industries and enterprises to be able to respond to changing patterns of end-market demand. Supporting markets *support* the core product market—providing the services and products needed to grow, upgrade and/or increasingly specialize.

Both finance and business services are commonly viewed as key to the effective response capacity of firms, but often these services are viewed as being supplied by stand-alone institutions such as banks, other financial intermediaries, consulting firms, and other providers of technical assistance. In many cases, however, services—both financial and business—are provided by actors within a supplier chain. Both buyers up the chain and input suppliers down the chain can be key sources of finance, technical assistance, and learning and innovation.

6.3. FIRM-LEVEL UPGRADING AND SUPPLY RESPONSE

Firm-level upgrading is essential for achieving productivity increases, skill development, employment growth, and competitiveness. Humphrey and Schmitz distinguish four types of upgrading:

Process upgrading: transforming inputs into outputs more efficiently by reorganizing the production process or introducing superior technology.

Product upgrading: moving into more sophisticated product lines with higher unit values.

Functional upgrading: acquiring new functions in the chain (or abandoning old functions) to increase the overall skill content of activities.

Inter-sector upgrading: using the knowledge acquired in particular chain functions to move into different sectors.[16]

Firms' abilities to achieve these various forms of upgrading depend in part of their position in the value chain and the governance system that applies to them, since these factors help to shape the incentives that firms face. Firm-level upgrading requires access to supporting markets: information, technology, and capital or finance.

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[16] John Humphrey and Hubert Schmitz, "Chain Governance and Upgrading: Taking Stock" in Hubert Schmitz, ed. *Local Enterprises in the Global Economy: Issues of Governance and Upgrading* (Cheltenham, 2003).

6.4. INTER-FIRM POWER RELATIONSHIPS AND INCENTIVES AFFECTING SUPPLY RESPONSE

A functional market system with a sound enabling environment is integral to creating competitive advantage at the national, value chain, industry, and firm levels. A market system operating within a sound enabling environment will have the following characteristics:

- An efficient flow of goods, services, and money.
- Effective exchange of information on market demand, prices, and product standards.
- Continuous learning, innovation, and adaptation in response to market demand.
- A fair distribution of benefits, so that all economic entities receive market incentives.

In addition to the above, a functional market system requires that the relationships among firms that transact with each other offer all participants the ability and incentives to upgrade, act as a good faith supplier, act in a transparent fashion, and move toward higher levels of productivity. In other words, a market system—made up of transacting firms—must facilitate learning and innovation and productive collaboration by economic entities, and must distribute the benefits of market participation up and down the value chain.

Learning and innovation: The acquisition of new knowledge and skills is not necessarily a straightforward process. Learning and innovation are closely tied to the incentives that either encourage or discourage the delivery and absorption of new knowledge or skills, as well as by the mechanisms in place that can transfer skills and knowledge.

What is straightforward is that for any industry to compete over time, it needs to operate in a competitive environment that creates incentives for innovation to improve basic firm operations, inter-firm cooperation, vertical linkages, and markets for services and products that support the value chain. For firms and industries to innovate continuously for better performance, there have to be mechanisms to transfer skills and know-how to firms and industries that can put them to good use. The industries that institutionalize learning mechanisms are the most competitive over the long run.

Productive Collaboration: Productive collaboration by economic entities is characterized by *win-win* relationships. Value chain governance shapes the incentives that drive behavior and determine how much particular firms benefit from participation in the industry. Patterns vary from highly dependent systems in which one party dominates to balanced systems in which all involved parties have some power to wield. Power in commercial relationships derives primarily from ownership of some key determinant that shapes product demand. For example, unbranded food products are typically purchased based on the confidence that consumers have in the retail store selling the food. This gives the supermarkets and other retail outlets market power. If the product is branded and consumers have a strong brand preference (e.g., Coca-Cola), the power usually resides with the manufacturer.

Regardless of such power asymmetries, the more transparent, long-term, and focused commercial relationships are, the greater clarity all parties have about the costs and benefits of doing business. Highly informal, arm's length relationships often encourage commitment failure by MSEs, predatory behavior by lead firms and traders, and reluctance by all parties to risk innovation, since benefits, costs, and mutual dependency are unclear.

Distribution of Benefits: Closely related to the concepts of power relationships and learning is the idea of benefits. Benefits to MSEs include not just income but also reduced market risk (more stable income) and increased value of assets. The dynamics that determine where and how benefits accrue are tied to the wielding of market power and whether innovation and learning are actively encouraged through appropriate mechanisms. A reasonably “fair” distribution of benefits (adequate risk/return tradeoff) is also necessary to incentivize market participation at all levels of the value chain.

The distribution of benefits depends on the number and nature of vertical linkages, the effectiveness of cooperation to address joint constraints, and the depth and robustness of support markets—all of which hinge on the quality of the enabling environment. Artificial or highly distorted distribution structures that result from predatory behavior in vertical linkages, lack of effective response to joint constraints, and/or weak or non-existent support markets can exacerbate a cycle of behavior that skews the flow of benefits and ultimately limits the competitiveness of an industry.

7. THE NEW GENERATION OF PSD PROGRAMMING: STRATEGIC INTERVENTION ISSUES

Donor market interventions are appropriate when markets fail. Classic examples of market failures that justify interventions include public goods, positive and negative externalities, monopolies, and information asymmetries. [17] Equity concerns provide yet another justification for donor interventions.[18]

Regardless of the justification for intervention, PSD program designers face a set of common strategic decisions. We see four tiers of strategic decision making:

Tier 1: Improve the business enabling environment, strengthen the supply response, or pursue a combination of the two?[19]

Tier 2: Specialize or integrate?

Tier 3: Implement what specific interventions?

Tier 4: Intervene directly, facilitate, or pursue a combination of the two?

7.1. TIER 1: BUSINESS ENVIRONMENT VS. SUPPLY RESPONSE VS. A BALANCED APPROACH

The first strategic decision PSD program designers must make is which of three basic intervention strategies to take. They can:

Limit interventions to improving the business environment, leaving supply response to private enterprise. An orthodox view expressed by many academic and World Bank economists is that interventions ought to be limited to those targeting improvement of the business environment. They argue that in a reasonably open and well-functioning market system, private firms are better suited to decide what to produce, how to produce, and where to sell than are policy makers or donors,

[17] Public goods (e.g., justice and national defense) must be consumed by everyone at once and thus must be collectively financed to avoid the “free rider problem.” Goods with external benefits or costs (e.g., inoculations, on the one hand, and goods produced in polluting factories, on the other) will be supplied by the private sector, but not in optimal amounts. Efficiency will be enhanced if activities with positive externalities are subsidized and activities with negative externalities are taxed. Monopolies produce sub-optimal quantities of output and charge excessive prices. They need to be broken up or regulated. Imperfect or asymmetric information between buyers and sellers may cause producers to miss out on market opportunities or not to negotiate the best possible deal. These require market interventions aimed requiring full disclosure and improving the communication infrastructure.

[18] An equity basis for intervention might involve, for example, “merit goods” (e.g., primary health care, primary education, clean water) that could be regarded as basic human rights. A good discussion of market failure appears in Swedish Development Cooperation Agency (SIDA), *Making Markets Work for the Poor* (Stockholm, 2003), pp. 34-36.

[19] Efforts to boost or otherwise shape end-market demand are a third, but less important, possibility.

who seldom excel at “picking winners.”[20] They also contend that no special preference should be accorded to MSEs just because they are small.[21]

Critics of the orthodox line charge that, in many cases, policy reforms have failed to bring about the desired or predicted impact. To this, defenders of the orthodox position may retort that the reforms did not focus sufficiently on micro-level issues,[22] were not implemented with sufficient vigor, or were not given enough time to show results. Critics in turn contend that policy reform is not enough—that work to stimulate the supply response is also needed and, indeed, is the more important and challenging part of PSD.[23]

The importance of improving the quality of the business environment has gained strong and widespread acceptance in recent years. Few donors and practitioners, however, would go so far as the orthodox economists and contend that only interventions to improve the business environment are legitimate.

Emphasize the strengthening of enterprise supply response. Market failure, especially asymmetric or inadequate information, can justify temporary intervention to help firms in developing countries learn how to compete.[24] Firm-level interventions (training and technical assistance) are the traditional approach to strengthening supply response. Many problems have arisen in the past and many traditional interventions are now regarded as ineffective, inefficient, and unsustainable. At least in principle, the current idea is to supply services to enterprises on a market-driven, sustainable basis.

Take a balanced approach, combining selective supply-side interventions with efforts to improve the business environment. Many donors are now designing and implementing projects that combine supply-side approaches, often value chain interventions, with measures to improve selected features of the business environment. The PSD projects currently being formulated by the World Bank Group for seven African countries take what might be called a “Chinese restaurant menu approach.”[25] Each project contains measures in three areas: deepening and widening business finance; strengthening business services; and improving the business environment. The particular

[20] This is a phrase used by economists to refer to efforts by policy makers or donors to select promising industries, sub-sectors, or businesses on which to focus their interventions. There has been, for example, a large controversy about the role that “industrial policy” (the promotion of particular industries and firms that were expected to accelerate economic growth and technological upgrading) played in the development of East Asian “Tigers” such as South Korea and Taiwan. Many economists doubt that these selections can be made effectively by politicians or bureaucrats and prefer to leave decisions to business actors who may be better informed and have a larger stake in the outcome. Supply-side interventions undertaken despite this concern may seek ways to “let the winners pick themselves”—that is, to structure programs so that participation is determined as much as possible by the actions of the participants themselves.

[21] See Ian M. D. Little, Dipak Mazumdar, and John M. Page, Jr., *Small Manufacturing Enterprises: A Comparative Study of India and Other Economies* (New York: Oxford University Press for the World Bank, 1987). More recent and nuanced statements of the World Bank position are Michael U. Klein and Bita Hadjimichael, *The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Outcomes* (Washington, D.C.: World Bank, 2003); and *World Development Report 2005. A Better Investment Climate for Everyone* (Washington, D.C.: World Bank).

[22] For example, it is widely believed that reform in Latin America overemphasized the macroeconomic level and paid insufficient attention to microeconomic and regulatory matters.

[23] For a vigorous statement of this position, see Michael Fairbanks and Stace Lindsay, *Plowing the Sea. Nurturing the Hidden Source of Growth in the Developing World* (Boston: Harvard Business School Press, 1997).

[24] When market failures are used to justify supply interventions, however, it is important that they not be replaced with government failures such as incompetence, under-funding, or corruption. Another danger is that interventions may benefit only a few well-placed businesses and not reach a wider range of firms or benefit society broadly.

[25] The countries concerned are Ghana, Kenya, Madagascar, Mali, Nigeria, Tanzania, and Uganda. The projects are sponsored jointly by the International Development Association (IDA) and the International Finance Corporation (IFC).

measures included in each project are selected from the list of potential interventions in each area ("Column A, Column B, and Column C") to fit the perceived needs of the country in question.

Similarly, donor support of microfinance programs has incorporated business environment, supply-side, and demand-side interventions in a variety of different combinations. Interventions have included policy advocacy targeting regulatory and legal reform, funding and technical assistance to expand loan outreach, and training and technical assistance in marketing and market research.

Rather than focus on either the business environment or supply-side interventions, the general trend at USAID and other donors is to combine both emphases in an effort to craft a balanced approach to PSD programming.

7.2. TIER 2: SPECIFIC INTERVENTIONS VS. INTEGRATED PROGRAMMING

A different kind of decision that donors face in designing their PSD programs is whether to concentrate on one or a small number of specific interventions that deal with a limited number of presumably critical barriers to PSD (e.g., improving small business access to finance or strengthened general managerial capacity) or to design an integrated package with a larger set of interventions that may be expected to work together to achieve a greater impact than from just one or two measures.

Donors' approaches to this question have evolved over time. Before the mid-1990s, specific approaches were most common—often financial or technical assistance supplied at the firm level. In recent years, however, donors have increasingly pursued integrated strategies for stimulating PSD. A review of donor-supported PSD programs by the AMAP BDS K&P Component D team identified a large number and wide variety of PSD interventions.[26] Supply-side interventions have carried a variety of labels, including MSE development programs, business development services (BDS), market development programs, microfinance (or financial sector deepening), competitiveness, trade and investment promotion, agribusiness, and sub-sector, value chain, and cluster development.

7.3. TIER 3: CONTENT OF INTERVENTION PACKAGES

The next strategic question donors must address is which specific interventions to implement. The issue arises regardless of whether the Tier 2 choice is to emphasize the business environment, supply response, or a balance of the two. While their goals may differ to some degree,[27] donors select from a common menu of potential interventions.

[26] See Snodgrass (2005). The donors covered by this review were USAID, the World Bank Group, DFID, and the Inter-American Development Bank.

[27] Program goals at USAID-supported PSD projects in developing countries generally focused on income, value added, competitiveness, and managerial capacity at the enterprise and producers' association levels. In transition countries, major USAID goals were to strengthen the private sector, mobilize private interests to push for policy and regulatory reform, improve understanding of how a competitive private sector works, and achieve competitiveness in regional and global markets. By comparison, DFID programs tended to promote achievement of the Millennium Development Goals through pro-poor economic growth and PSD. It furthered these objectives by encouraging the state, the private sector, and civil society to cooperate in achieving market solutions (see Snodgrass, 2005).

7.3.1. IMPROVE THE BUSINESS ENVIRONMENT

In the past few years, it has become increasingly common for PSD projects to include interventions aimed at improving the business climate. Specific intervention options include those related to regulatory reform; development of local legal and regulatory enforcement capacity; national policy assessment, reform, and development; international agreements and national standards; and trade and investment programs.

Regulatory reform. Three types of regulatory reform effort can be distinguished: 1) measures to improve the environment for private business in general; 2) measures to smooth the way for promoted value chains and clusters; and 3) efforts to reduce the regulatory bias against MSEs. Instruments of reform include such actions as deregulation, decentralization of regulatory functions, "one-stop shops" (simplified approval processes), tax simplification, improvements in contract enforcement, and building advocacy/stakeholder groups. Sometimes the focus of regulatory reform is broad, with an effort made to improve investment and operating conditions for many different kinds of businesses. In other cases, the sought-after improvements relate more narrowly to the specific value chains or clusters that the project is trying to promote.

In the past, donors often urged host governments to improve their business regulatory frameworks; improvements were sometimes required as explicit conditions of foreign assistance. Over time, however, donors decided that deregulation and other improvements could be pushed more effectively by local business organizations than by the donors themselves. Building advocacy capacity in business member organizations has thus become a common goal in the PSD projects of many donors and is now regarded as one important rationale for interventions to strengthen business organizations. In the past few years, USAID projects in many countries have combined policy advocacy with supply-side interventions.[28]

Local economic development and enhancement of legal and regulatory enforcement capacity. Local government promotion efforts and enforcement practices affect the ability of the private sector to participate in and benefit from market opportunities. Poor local government operations and enforcement of legal and regulatory regimes increase transaction costs, informality, and commitment failure risks. They shorten business cycles, limiting investments in relationships and upgrading. Activities to deal with these problems can make significant contributions to PSD.

National policy assessment, reform, and development. National economic policies can have dramatic effects on the functioning of markets and enterprises. Unclear or non-transparent processes for policy development limit incentives to effectively monitor and evaluate implementation and enforcement practices, leading to a lack of accountability and increased corruption. Significant contributions to PSD can also be made in this area.

International agreements and market standards. Increasingly, the relevant business environment for developing country enterprises is not just national but also international. International agreement organizations such as WTO and private sector industry associations such as EUREPGAP (a set of standards adopted by European supermarkets) are having an effect on how business is conducted, even at local levels.

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[28] The list includes projects in Albania, Armenia, Bangladesh, Bolivia, the Caribbean region, Colombia, Croatia, Egypt, El Salvador, Georgia, Honduras, Jamaica, Jordan, Kenya, Kosovo, Malawi, Mali, Mexico, Morocco, Palestine, the Philippines, Russia, Senegal, Southern Africa, Sri Lanka, Tanzania, and Uganda.

Trade and investment programs. This group includes programs intended to build trade capacity, reduce constraints on foreign direct investment, reform customs, improve communications, and meet certification requirements imposed by foreign markets. USAID and other donors have a number of such programs.

Other measures. The areas in which there is significant current donor programming by no means exhaust the range of possible interventions to improve the business environment. Infrastructure investment (roads, ports, railroads, airports, etc.) was often emphasized in the past but are seldom mentioned currently; yet the quality a nation's infrastructure remains an important determinant of the cost of doing business. Another important but currently neglected area is improvement in human capital, including simple literacy as well as middle- and higher-level skills.[29]

7.3.2. STRENGTHEN THE SUPPLY RESPONSE

USAID has been shifting in recent years from specific concern with developing MSEs as such to programs that promote the competitiveness of selected value chains and clusters and simultaneously try to integrate MSEs into these networks on more favorable terms. Along with increased appreciation of the importance of linkages has come a common emphasis on capacity building in BMOs to strengthen these linkages. According to the AMAP review of USAID-supported PSD programs, two-thirds promoted either clusters or value chains, usually in agriculture or agribusiness, and more than 90 percent worked with BMOs of one type or another, often business associations, cooperatives, or farmers' associations.[30]

The strengthening of supporting markets constitutes a further supply-side intervention category. Interventions to strengthen supporting markets can be either sector specific or general.

Strengthen value chains. Projects that take the value chain approach focus on a sub-sector. They try to form producer groups; facilitate improved inputs, business services, and finance; create or strengthen business linkages that give access to superior product markets; improve competitive strategies; and develop and/or apply new technologies. These projects emphasize vertical linkages along the value chain.

Before intervention, MSEs often are not connected to value chains that reach beyond their local community. Facilitating the establishment of linkages to more distant markets that operate on a rational and commercial basis is often one of the initial steps needed to provide MSEs with more promising market opportunities. The participation of lead firms, that bring strong market contacts into the mix, is also critical to the success of value chain interventions.

USAID has taken the lead in championing the value chain approach (and to a lesser degree the cluster approach). It now believes that the key to MSE success—even, in some cases, to their survival—is helping them link into value chains that will provide them with better markets for their outputs and stronger incentives to grow and upgrade.[31]

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29 To cite just one example of the potency of investment in human capital, Malaysia went from a natural resource-dependent economy to a highly industrialized one in the 1970s and 1980s, attracting large amounts of foreign investment primarily through the availability of literate, English-speaking unskilled labor. The fact that wages were higher in Malaysia than in most neighboring countries did not deter investors, given the quality of Malaysian human resources and physical infrastructure.

30 See Snodgrass (2005). Many of the projects that did not group clients were small. Almost half of them were in Eastern Europe and Central Asia.

31 In some cases, globalization is creating an international business environment is less favorable for MSEs and intervention may be needed merely to offset or ameliorate negative developments.

Other donors also use value chain and cluster approaches in some cases, but their program designs are more varied. A few World Bank Group[32] projects have tried to facilitate business linkages that enhance transactions, often working through lead firms, but most do not take a linkage or value chain approach. Instead, they emphasize training and capacity building and typically address a narrow range of issues. If a project focused on an industry, the goal was not so much to understand the market demand for the product or service supplied as to build up the capacity of those who would supply the good or service.

Strengthen clusters. Projects that take the cluster approach focus on local relationships among producers and support institutions that complement each other and strengthen national or local competitiveness. Michael Porter, who inspired this approach, argues that globalization (somewhat paradoxically) increases the importance of local business relationships.

USAID has instituted several cluster-based competitiveness projects in developing and transition countries. Horizontal cooperation needs to be fostered in every case where a joint constraint arises. The key to gaining value from horizontal cooperation is the recognition of a joint constraint that requires collective action.

Strengthen and deepen enterprise and/or value-chain finance. The big breakthrough of the past 25 years was the creation of a sustainable model for MSE finance, which has been shown to work in a wide range of environments. In many countries, though, financial systems still do not work well enough to ensure access to credit for all worthy business borrowers. Some observers argue that micro and large firms can get credit but small and medium-sized firms in expansion mode cannot. In recent years, there has been new attention to small and medium-sized enterprise and rural finance and sustainable strategies for reaching into rural areas as well as small (larger than micro) enterprises. Value chain finance is a means of assessing and addressing the needs of all sized firms in an industry.

Strengthen supporting markets. Supporting markets include those that provide valued services to MSEs operating within sectors, value chains, and clusters. Examples include financial services, BDS, veterinary services, repair services, transportation services, and so on. Development of financial markets and BDS has been emphasized in recent years, although the latter is now declining in popularity.

Generalized BDS—such as how to manage a business, accounting, and marketing—are less relevant to value chains that are dysfunctional or disconnected. Demand for these services typically follows the growth of demand for sector-specific services. They are best utilized by lead firms, especially in export industries, since these firms need competencies to compete in more mature markets.

Strengthen BMOs. In the shift from program designs that work with individual firms and entrepreneurs to programs that try to strengthen different kinds of relationships among firms (see below), BMOs of different kinds are seen as mechanisms for improving access to product and input markets, as well as to embedded business services. These projects usually aim to form or support organizations that will promote the development of a value chain or cluster. While improving the productive capacity of firms continues to be emphasized, donor interventions are now more likely to work through BMOs than through direct contact between the donor program and the firm.

In a number of instances, donors promote BMOs without sufficient understanding of the incentives needed to induce local firms with common interests to come together. Rather than ensuring the

[32] Including, in this case, the World Bank, IDA, and IFC.

existence of incentives, BMOs become the end in themselves. Such approaches are not effective. Moreover, BMOs in many countries are politicized and do not represent the best interest of their members. Rather than pushing BMOs, donors are better off promoting incentives for collective action, which may or may not take the form of a registered and/or formal organization or BMO.

7.3.3. STRENGTHEN END-MARKET DEMAND

Although end-market demand is effectively given in many circumstances, limiting the range of possible demand-side interventions, some donor interventions aim at strengthening demand for the goods and services produced by targeted enterprises and industries. Most demand-side interventions focus on marketing the capacity of firms or industries and improving their ability to differentiate themselves from competitors through, for example, branding.

Marketing. Marketing is a basic business activity aimed, among other things, at increasing end-market demand through product differentiation. MSEs, MSE networks, and MSE support institutions often lack basic training and skills in general marketing activities, or they may possess marketing skills that require upgrading. Donors have invested considerable resources in training and technical assistance for MFIs and MFI networks in marketing and market research.

Value chain or cluster linkages also offers intriguing opportunities for demand-side interventions. One such intervention is to improve the effectiveness of marketing efforts by lead firms in value chains thereby indirectly increasing the demand for products supplied to the lead firm by firms lower in the value chain. Another option is to strengthen the overall marketing capabilities of cluster or network members.

Branding. Working through clusters offers opportunities to leverage resources to pursue a variety of other marketing activities of benefit to cluster members. Sometimes efforts are made to establish a market niche for a good or service through advertising. Such advertising campaigns try to attach a brand name to the exports of a particular country, thereby creating distinctions in the consumer’s mind that would justify charging more than the consumer would have to pay for a similar product or service from another source. Such efforts are often part of cluster projects. For example, USAID’s competitiveness project in Sri Lanka helped the gem industry establish a niche market for the “Ceylon sapphire.”

One sector where efforts to boost demand are critical is tourism. Tourism is an ideal arena for cluster projects because the business prospects of the various players in the industry (airlines, cruise lines, hotels, tour operators, restaurants, etc.) are interdependent. A hotel on a Caribbean island needs advertising of tourism to that island even more than it needs advertising for the hotel itself. Each potential tourist destination is unique in various ways, and promotional efforts can zero in on the market segment that the cluster has a chance to attract and would like to woo, informing potential visitors of the attractions of local tourist destinations and trying to entice visitors to them.

7.4. TIER 4: DIRECT SERVICE PROVISION VS. FACILITATION

A final decision that donors must make is whether to provide services directly or to build the capacity of local entities to provide the needed services. Earlier supply-side interventions tended to concentrate on direct provision of training and technical assistance to individual firms, entrepreneurs, and workers. This type of activity is now generally regarded as ineffective and inefficient. The large number of clients, the wide variety of needs for training and technical assistance, and the fact that many MSEs were selling to stagnant markets made direct service provision ultimately unsustainable.[33]

The recognition that direct provision of business services and finance was often ineffective and non-sustainable led to a shift away from direct provision and toward the facilitation of service provision by others, including both for-profit businesses and nongovernmental organizations. The facilitation is supposed to be temporary, leading in time to sustainable provision on a cost-recovery basis. In practice, this ideal is often realized slowly if at all. Everyone appreciates a subsidy and nongovernmental organizations often find it difficult to convert themselves to for-profit business.[34] Some projects combine direct provision with facilitation, expecting that the direct provision will be phased out over time.

Market facilitation of business services is referred to as the *BDS market approach.* The success of the market approach to microfinance in making microfinance sustainable in a wide range of settings inspired an effort to achieve similar success with non-financial services. In the late 1990s, major donors agreed to pursue the BDS market development approach, effectively transforming donors from direct providers of training and technical assistance to facilitators of their provision by local consultants in an effort to build a sustainable local business service industry.

Implementation of BDS market development approach, however, has been spotty. Many donors continue to subsidize business services through vouchers and matching grants and do not always build exit strategies for ending such subsidies into their project designs. The World Bank Group, for example, continues to offer business services directly to enterprises in combination with training business service providers.[35]

While some donors continue to implement BDS programs, enthusiasm for the approach has waned. USAID in particular has since switched to a stronger emphasis on inter-firm linkages in value chains and clusters, realizing that many business services, especially those supplied to MSEs, are not supplied in freestanding markets but are instead embedded in commodity transactions that take place along value chains. All seven of the projects nominated by USAID's Office of Microenterprise Development as "good" projects for the AMAP review of donor-sponsored PSD programs involved linkages through value chains or clusters.[36]

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33 See the argument to this effect in Donald Snodgrass and Tyler Biggs, *Industrialization and the Small Firm: Patterns and Policies* (San Francisco: International Center for Economic Growth, 1996), pp. 127-146.

34 This often involves reductions in salaries and benefits, which are naturally resisted.

35 Most World Bank interventions are still subsidized and there is usually no clear strategy for achieving commercial sustainability.

36 JOBS in Bangladesh, which is implemented by the Iris Center of the University of Maryland; CDA in Honduras (Fintrac); SEPA in Mali (AFE); MAPP in Morocco (DAI); PRA in Peru (Chemonics); and IDEA and COMPETE in Uganda, which are implemented by Carana and Chemonics respectively. For more detail, see Snodgrass (2005), pp. 41-42, 79-80.

8. PSD PROGRAM SETTINGS

PSD programs have been launched in a wide variety of country settings. For the purpose of program planning, it is helpful to divide countries into groups sharing common characteristics. USAID currently divides the developing world into two groups of countries that pose differing challenges for assistance efforts:[37]

> *Relatively stable countries* where government commitment (measured by governance and policy performance) ranges from weak to very good and foreign aid can, to varying degrees, support development progress.
>
> *Fragile states*, including some that are on a downward spiral toward crisis and chaos, some that are recovering from conflict, and others that are essentially failed states.

USAID does not label individual countries as fragile states, noting that "there is considerable debate about which countries should be considered fragile states and (more importantly) whether and how foreign aid can make a contribution." It stresses that while most fragile states are low-income countries, not all low-income countries should be considered fragile states.[38]

Other criteria for classifying potential aid-receiving countries include per capita income, the size of the national economy, the growth rate of GDP, political stability, and the legal/regulatory regime. Based on these criteria, the following country classifications have been identified.

Low- and middle-income economies: Enterprises in most USAID-assisted countries face small local markets with low purchasing power. In many of these countries, GDP per capita has grown slowly if at all in the past 10 to 15 years. Included among low- and middle-income economies are the post-socialist, or transition, economies of Europe and Eurasia. The AMAP program review found that about two-thirds (102) of USAID's PSD projects were located in developing countries and about one-third (47) were in the post-socialist economies of Europe and Eurasia.[39] Nearly one-third (47) were in Sub-Saharan Africa.

Of the 102 projects in developing countries, half (51) were located in low-income countries, 38 in lower-middle income countries, and only 3 in upper-middle income countries.[40] Looked at another way, 41 of these projects were located in countries that have achieved little or no growth in per capita income since 1990. Low and slow-growing income stifled PSD in these countries. Improved integration of the domestic market and sales to regional neighbors offer some opportunities for business expansion, but export sales are needed to escape the domestic demand constraint and boost sales.

Donors other than USAID concentrate more on developing countries. The U.K. Department for International Development works mainly in former British colonies, particularly in Africa. A slightly higher proportion of its projects are in low-income and stagnant/declining economies than is the case for USAID. About half of the World Bank Group's PSD projects are in Sub-Saharan Africa, but Bank Group projects are spread widely over low- and middle-income countries and among stagnant and

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[37] See Bureau for Policy and Program Coordination, U.S. Agency for International Development (2004). *U.S. Foreign Aid: Meeting the Challenges of the Twenty-first Century,* p. 13.

[38] Ibid. The World Bank maintains a list of 30 "low-income countries under stress," while DFID counts 46 "fragile states." *The Economist,* March 5-11, 2005.

[39] For more detail, see Snodgrass (2005), pp. 18ff.

[40] Ten projects took place in more than one country.

growing economies. The Inter-American Development Bank (IDB), of course, works only in Latin America and the Caribbean, a region primarily of middle-income countries that grew slowly if at all from 1990 to 2002.

Transition economies: Post-socialist countries in Europe and Eurasia can be classified by the degree of success they have achieved in recovering from the sharp economic decline that they all experienced after the break-up of the Soviet Union. Income levels in all these countries fell until around 1993. Many countries had not regained their 1990 income levels by 2002, and some of those remained essentially stagnant, while other countries were doing better, and a few had passed their 1990 income levels by 2002.[41] As in the developing countries, small, stagnant, and/or slow-growing economies heighten the importance of exports. This is a particular challenge for the transition economies, since their production systems and trading patterns were all geared to the Soviet Union and now must be redirected toward global trade.

Large and small economies: The size of the domestic market depends not just on GDP per capita but also on the size of the national population. As Table 1 shows, most of the countries with USAID PSD projects have very small domestic markets (GDP in 2003 below $10 billion). Only two of them (Russia and India) exceed the domestic market size of Belgium, a relatively small European economy.[42] A few more client countries (South Africa, the Philippines, Bangladesh, Ukraine, and Morocco) had markets of $40 billion or more, but nearly all USAID clients in Sub-Saharan Africa and Central Asia had domestic markets of less than $10 billion in 2003.

Growing and stagnant economies: The other part of the demand problem is that domestic markets in most assisted countries are not growing very rapidly. Only Armenia, Mozambique, and Vietnam experienced what could be called rapid growth in the size of their domestic markets from 1993 to 2003 (Table 1). Albania, Angola, Uganda, Bangladesh, and India did reasonably well with GDP growth of 5 to 7 percent a year. The other 40 countries with USAID PSD programs grew at less than 5 percent a year in aggregate terms in 1993-2003. Haiti and Ukraine suffered declining real GDPs during this decade.

Conflict and post-conflict states: USAID often works in post-conflict situations or even where there is ongoing instability or outright conflict. These circumstances greatly complicate the business environment, especially by increasing risk, destroying infrastructure, making natural resources inaccessible, and traumatizing entrepreneurs and workers. However, they may also weaken traditional opposition to reform and open up new opportunities for private enterprise.

Good and bad business environments: Other things equal, enterprises develop better in business environments that offer low transaction costs and risks than in bad business environments. The countries in which USAID has PSD projects generally rank low on the business environment indicators collected by the *Doing Business* project. Table 2 looks at just one measure of the legal and regulatory environment: the cost of opening a business, expressed as a percentage of income per capita. In developed countries, this cost is usually less than 5 percent.[43] In developing and transition

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[41] The countries that had USAID enterprise development projects and had passed their 1990 GDP per capita levels are Albania, Azerbaijan, Bulgaria, and Croatia. Those that were growing but had not yet reached their 1990 levels by 2002 were Armenia, Georgia, Mongolia, and Romania. The weakest group, which experienced declining GDP per capita from 1993 to 2002, or growth at less than 1 percent a year, included Kosovo, Macedonia, and Russia.

[42] Belgium's population totaled 10.3 million and its GDP in 2003 (measured in at 1995 prices) was $325 billion. Russia and India, with vastly larger populations, had GDPs of $506 billion and $559 billion by the same measure.

[43] In New Zealand, Sweden, the United Kingdom, and the United States it costs less than 1 percent of per capita income to open a business. At the high end of the range for developed countries, the cost of opening a business is 10.6 percent in Japan, 11.3 percent in Belgium, 16.2 percent in Italy, and 16.5 percent in Spain.

countries where USAID has PSD projects, the figure is invariably higher, in several cases exceeding per capita income. Yet many of these countries rate better on this criterion, with costs for opening a business of 20 percent or income per capita or less.

Regulatory bias against MSEs: Despite myriad national policy statements favoring small business, regulatory frameworks are generally biased against smaller firms. Whenever there is a cost involved in complying with business regulations and the cost varies little with the size of the transaction; small firms pay more in percentage terms (assuming that they must comply) than larger firms.[44] The global analysis of Schiffer and Weder (2001, p. 37) confirms "that there is a systematic bias against small and medium firms," that "the pattern of bias against small firms is most pronounced in Latin America and the Caribbean and transition economies," and that "the analysis of different obstacles reveal that the biases are quite consistent across obstacles." Deregulation usually reduces the extent of this bias. In addition to reducing regulatory obstacles to the formation and operation of private businesses in general, the goal of creating a "level playing field" for enterprises of different sizes is also appropriate in many settings.

TABLE 1: MARKET SIZE AND GROWTH RATE IN COUNTRIES WITH USAID PSD PROJECTS (ANNUAL AVERAGE GROWTH RATE OF GDP, 1993–2003)

GDP in 2003	Less than 3%	3-5%	5-7%	More than 7%
Less than $10 billion	Benin	Azerbaijan	Albania	Armenia
	Haiti	Bolivia	Angola	Mozambique
	Honduras	Ethiopia	Uganda	
	Jamaica	Georgia		
	Kyrgyz Rep.	Ghana		
	Macedonia	Guinea		
	Madagascar	Jordan		
	Moldova	Namibia		
	Paraguay	Nicaragua		
	Tajikistan	Tanzania		
	Uzbekistan	Turkmenistan		
	Zambia			
	Zimbabwe			
$10-50 billion	Bulgaria	Croatia		Vietnam
	Kazakhstan	El Salvador		
	Kenya	Guatemala		
	Romania	Morocco		
		Nigeria		
		Sri Lanka		
More than $50 billion	Egypt	Philippines	Bangladesh	
	Russia		India	
	South Africa			
	Ukraine			

SOURCE: World Bank, World Development Indicators 2005.

[44] See discussion in Snodgrass and Biggs (1996).

TABLE 2: COST OF STARTING A BUSINESS IN COUNTRIES WITH USAID PSD PROJECTS (% OF INCOME PER CAPITA)

Less than 10%	10-20%, 20-50%, and 50-100%		More than 100%	
Armenia	Azerbaijan	Albania	Bangladesh	Angola
Romania	Bulgaria	Bosnia	Egypt	Benin
Russia	Croatia	India	Ethiopia	Bolivia
South Africa	Georgia	Vietnam	Ghana	El Salvador
	Jamaica	Zambia	Guatemala	Guinea
	Kazakhstan		Honduras	Haiti
	Kyrgyz Rep.		Kenya	Nicaragua
	Macedonia		Madagascar	Paraguay
	Moldova		Nigeria	Tanzania
	Morocco			Uganda
	Namibia			Zimbabwe
	Philippines			
	Sri Lanka			
	Ukraine			

SOURCE: World Bank. 2005. *Doing Business in 2005: Removing Obstacles to Growth.* Washington: World Bank, International Finance Corporation, and Oxford University Press, pp. 89-91.

9. DETERMINING THE IMPACT OF NEW GENERATION PSD PROGRAMS: A LEARNING AGENDA

Impact assessment, the subject of the next paper in this series, has great potential for determining whether the various PSD interventions discussed in this paper are achieving their objectives of promoting competitiveness and contributing to economic growth with poverty reduction. Impact assessment is a technique for measuring the effects of interventions by comparing observed outcomes to a counterfactual—an estimate of what would have happened if the program has not been undertaken. It differs from project monitoring, which merely observes what happens as a project unfolds and concentrates on the earlier links in the project's causal chain, rather than its higher-level objectives. It also differs from USAID's Performance Management Plan (PMP), which establishes a hierarchy of objectives and a set of indicators to measure progress toward those objectives but cannot show how much of the observed progress is attributable to the programs undertaken. Impact assessment does not evaluate the performance of project contractors, whose work may be good but still not lead to satisfactory impact if the project is poorly designed. It does seek to *prove* impact, thus justifying a programming approach and bolstering claims that resources should be devoted to the type of activity in question. It does aim to *improve* project design, thus benefiting practitioners who design and implement PSD projects.

The overall aim of AMAP BDS K&P Component D is to design and test impact assessment methodologies that are well suited to the new generation of PSD projects. Among the questions that can be addressed through this endeavor are:

- How can we measure the different kinds of impacts that new generation PSD programs try to achieve?
- Which of the possible approaches to PSD intervention produce the most impact?
- Does the setting in which a project is implemented affect its impact?
- Do new generation projects produce greater impact than older approaches, as most current practitioners believe?

We can only begin to suggest answers to these questions within the time and resource constraints of AMAP BDS. We will obviously not be able to assess the impact of each of the major interventions in each of the main types of settings in which they might be carried out. The fourth question above will be particularly difficult to answer because so few good impact assessments were done for the older projects. With learning, however, links to Components B and C of AMAP BDS, which deal respectively with project design and project interventions, will become evident. Good impact assessment can help to reconstitute a virtuous circle that has been broken for most of the past two decades. It can contribute to USAID's current effort to become more of a learning organization.

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